
NOTES TO THE FINANCIAL STATEMENTS

NOTE 3: DEPOSITS AND INVESTMENTS

A. Deposits and Investments with State Treasurer

Unless specifically exempt, every agency of the State and certain component units are required by General Statute 147-77 to deposit moneys received with the State Treasurer or with a depository institution in the name of the State Treasurer. Certain local governmental units that are not part of the reporting entity are also allowed to deposit money with the State Treasurer. Expenditures for the primary government and certain component units are made by warrants issued by the agencies and drawn on the State Treasurer. The State Treasurer processes these warrants each day when presented by the Federal Reserve Bank. General Statute 147-69.1 authorizes the State Treasurer to invest all deposits in obligations of or fully guaranteed by the United States; obligations of certain federal agencies; repurchase agreements; obligations of the State of North Carolina; time deposits with specified financial institutions; prime quality commercial paper; specified bills of exchange or time drafts; asset-backed securities; and corporate bonds and notes with specified ratings.

General Statute 147-69.2 authorizes the State Treasurer to invest the deposits of certain special funds, including the pension trust funds, the State Health Plan, the Disability Income Plan of N.C., the Escheats Fund, the Public School Insurance Fund, the State Education Assistance Authority, and trust funds of the University of North Carolina system, in the investments authorized in General Statute 147-69.1; general obligations of other states; general obligations of North Carolina local governments; asset-backed securities bearing specific ratings and obligations of any company incorporated within or outside the United States bearing specific ratings. The deposits of the pension trust funds may be invested in all of the above plus certain insurance contracts; group trusts; individual, common or collective trusts of banks and trust companies; real estate investment trusts; limited partnership interest in limited liability partnerships or limited liability companies; and certain stocks and mutual funds.

External Investment Pool

To ensure that these and other legal and regulatory limitations are met, all cash deposited with the State Treasurer, except for bond proceeds, is maintained in the Investment Pool. This pool, a governmental external investment pool, consists of the following individual investment portfolios:

Short-term Investment – This portfolio may hold any of the investments authorized by General Statute 147-69.1. The Short-term Investment portfolio is the primary cash management account for the State and is managed in such a manner as to be readily convertible into cash. The primary participants of this portfolio are the General Fund and the Highway Funds. Other participants include the

remaining portfolios listed below and various boards, commissions, community colleges, and school administrative units that make voluntary deposits with the State Treasurer.

Long-term Investment – This portfolio may hold the fixed-income investments authorized by General Statutes 147-69.1 and 147-69.2. Since the deposits in this fund are typically not needed for day-to-day operations, the investment vehicles used generally have a longer term and higher return than those held in the Short-term Investment portfolio. The primary participants of the portfolio are the pension trust funds and various special trust funds.

Equity Investment – This portfolio holds an equity-based trust. The State's pension trust funds are the sole participants in the portfolio.

Real Estate Investment – This portfolio holds investments in real estate-based trust funds and group annuity contracts. The State's pension trust funds are the sole participants in the portfolio.

Venture Capital Investment – This portfolio holds investments in venture capital limited partnerships, the long-term investment portfolio and equities received in the form of distributions from its primary investments. The State's pension trust funds are the sole participants in the portfolio.

All of the above investment portfolios operate like individual investment pools, except that an investment portfolio may hold shares in other investment portfolios at the discretion of the State Treasurer and subject to the legal limitations discussed above. To this extent, the deposits are commingled; and therefore, the State Treasurer considers all investment portfolios to be part of a single pool, the Investment Pool. The Investment Pool contains deposits from funds and component units of the reporting entity (internal portion) as well as deposits from certain legally separate organizations outside the reporting entity (external portion). This pool is not registered with the SEC and is not subject to any formal oversight other than that of the legislative body.

A complete set of the audited financial statements for the Investment Pool of the North Carolina Department of State Treasurer can be obtained from the Office of the State Auditor, 2 Salisbury Street, Raleigh, NC 27699-0601.

At year end, the condensed financial statements for the Investment Pool maintained by the State Treasurer were as follows (dollars in thousands):

NOTES TO THE FINANCIAL STATEMENTS**Statement of Net Assets
June 30, 2002**

Assets:	
Cash and cash equivalents.....	\$ 507,376
Other assets.....	491,982
Investments.....	<u>76,101,094</u>
Total assets.....	<u>77,100,452</u>
Liabilities:	
Distributions payable.....	28,667
Obligations under securities lending.....	<u>15,577,252</u>
Total liabilities.....	<u>15,605,919</u>
Net Assets:	
Internal:	
Primary government.....	58,980,871
Component units.....	1,981,414
External.....	<u>532,248</u>
Total net assets.....	<u>\$ 61,494,533</u>

**Statement of Operations and Changes in Net Assets
For the Fiscal Year Ended June 30, 2002**

Decrease in net assets from operations:	
Revenues:	
Investment income.....	<u>\$ (1,510,276)</u>
Expenses:	
Securities lending expenses.....	336,466
Investment management.....	<u>39,689</u>
Total expenses.....	<u>376,155</u>
Net decrease in net assets resulting from operations.....	(1,886,431)
Distributions to participants:	
Distributions paid and payable.....	(6,924,026)
Share transactions:	
Reinvestment of distributions.....	6,927,679
Net share purchases.....	<u>(1,829,964)</u>
Total decrease in net assets.....	(3,712,742)
Net assets:	
Beginning of year.....	<u>65,207,275</u>
End of year.....	<u>\$ 61,494,533</u>

The external portion of the Investment Pool is presented in the State's financial statements as an investment trust fund. Each fund and component unit's share of the internal equity in the Investment Pool is reported in the State's financial statements as an asset of those funds or component units. Equity in the Short-term Investment portfolio is reported as cash and cash equivalents while equity in the Long-term Investment, Equity Investment, Real Estate Investment, and Venture Capital Investment portfolios is reported as investments. The internal equity of the pool differs from the amount of assets reported by the funds and component units due to the typical banker/customer outstanding and in-transit items. Additionally, each fund reports its share of the assets and liabilities arising from securities lending transactions. The State reports the assets and liabilities arising from securities lending transactions for component units as part of the State's agency funds, rather than allocate them to the component units.

Investments in nonparticipating contracts, such as nonnegotiable certificates of deposit, are reported at cost. Other investments held in the Short-term Investment portfolio are reported at amortized cost, which approximates fair value. All

other investments are reported at fair value. Fair values are determined daily for the Long-term Investment portfolio, monthly for the Equity Investment portfolio and quarterly for the Real Estate Investment and Venture Capital portfolios. The fair value of fixed income securities is based on future principal and interest payments discounted using current yields for similar instruments. Investments in real estate trusts, venture capital limited partnerships, and the equity trust are valued using market prices provided by the third party professionals. Participants' shares sold and redeemed are determined in the same manner as is used to report investments, and the State Treasurer does not provide or obtain legally binding guarantees to support share values.

Net investment income earned by the Investment Pool is generally distributed on a pro rata basis. However, in accordance with legal requirements, the General Fund receives all investment income earned by funds created for purposes of meeting appropriations. For the fiscal year ended June 30, 2002, \$47,684,043 of investment income associated with other funds was credited to the General Fund.

Bond Proceeds Investment Accounts

The State Treasurer has established separate investment accounts for each State bond issue to comply with IRS regulations on bond arbitrage. A private investment company under contract with the State Treasurer manages these separate accounts. The investments are valued at amortized cost, which approximates fair value. In the financial statements, each fund's equity in these accounts is reported as cash and cash equivalents.

Demand and Time Deposits

Agency deposits to the Investment Pool may be made in any bank, savings and loan association or trust company in the State approved by the State Treasurer. Depositories are required, in accordance with the rules in the North Carolina Administrative Code (Chapter 20 NCAC 7), to collateralize all balances of the State Treasurer which are not insured. Basically, these rules require that the bank maintain, as collateral in an escrow account established by the State Treasurer with a third-party bank, securities of a type enumerated in the rules, in an amount whose market value is not less than the amount of the time deposits and the average balance of demand deposits for the preceding quarter less the allowable deposit insurance on the deposits. Generally, rules require the securities to be governmental in origin (e.g., U.S. Treasury and U.S. agency obligations, or state and local government obligations) or the highest grade commercial paper and bankers' acceptances. Financial institutions generally may elect to collateralize deposits separately (dedicated method) or to include the deposits of North Carolina local government units in the same collateral pool with the State and certain component units (pooling method). Financial institutions report quarterly on bank balances and amounts secured by insurance and amounts protected by securities. The State Treasurer maintains no records of financial institution balances of local governments collateralized in the pool with State Treasurer

NOTES TO THE FINANCIAL STATEMENTS

deposits. Since the amounts of local government deposits in the pooling method banks are not known, the risk of being under-collateralized at any given time is increased. Therefore, the institution's financial condition may cause the State Treasurer to require a particular institution to utilize the dedicated method exclusively for the protection of each public depositor.

At June 30, 2002, the deposits maintained by the State Treasurer consisted of (dollars in thousands):

	<u>Carrying Value</u>	<u>Bank Balance</u>
Demand.....	\$ 83,167	\$ 87,240
Time.....	159,746	159,746
Total Deposits.....	<u>\$ 242,913</u>	<u>\$ 246,986</u>

At year end, 94 percent of the balances in financial institutions were deposited under the pooling method. Because the financial institutions complied with the collateralization policies and procedures by utilizing either the dedicated method or the pooling method described above, the State Treasurer

considers all of its deposits to be either insured or covered by collateral held by the escrow agent.

Investments

Investments held by the Investment Pool and the bond proceeds investment accounts are categorized into three categories of credit risk to give an indication of the level of credit risk assumed by the entity at year-end. Category 1 includes investments that are insured or registered or for which the securities are held by the owner or its agent in the owner's name. Category 2 includes uninsured and unregistered investments for which the securities are held by the financial institution's trust department or agent in the owner's name. Category 3 includes uninsured and unregistered investments for which the securities are held by the broker or dealer, or by a financial institution's trust department or agent, but not in the owner's name. At year end, the balances of the Investment Pool maintained by the State Treasurer were as follows (dollars in thousands):

<i>Investment Pool</i> <i>Investments Categorized:</i>	<u>Category</u>		<u>Carrying Amount</u>
	<u>1</u>	<u>3</u>	
U.S. government and agency securities:			
Not on loan.....	\$ 1,603,620	\$ 746,727	\$ 2,350,347
On loan for securities collateral.....	279,484	—	279,484
Corporate bonds and notes.....	9,252,485	1,234,909	10,487,394
Asset backed securities.....	5,178,829	10,314,880	15,493,709
Repurchase agreements.....	264,463	3,280,736	3,545,199
International bonds.....	359,706	—	359,706
Domestic equities.....	2,255	—	2,255
Total Investments Categorized.....	<u>\$ 16,940,842</u>	<u>\$ 15,577,252</u>	32,518,094
<i>Investments Not Categorized:</i>			
Equity-based trust.....			27,032,435
Venture capital investments.....			39,978
Real estate trust funds.....			1,510,996
Investments held by broker/dealers under securities loans with cash collateral:			
U.S. government and agency securities.....			14,696,855
Corporate bonds and notes.....			528,205
International bonds.....			38,994
Total Investment Pool.....			<u>\$ 76,365,557</u>

During the year other investment types may have been owned by the Investment Pool, but all material investment types and categories are disclosed above. At year end, the major investment classifications of the Investment Pool had the following attributes (dollars in thousands):

<u>Investment Classification</u>	<u>Carrying Amount</u>	<u>Principal Amount</u>	<u>Range of Interest Rates</u>	<u>Range of Maturities</u>
U.S. government and agency securities.....	\$ 16,579,959	\$ 15,325,162	Zero - 9.125%	1 day - 29 years
Corporate bonds and notes.....	9,780,690	9,578,323	5.0 - 8.875%	4 years - 41 years
Asset backed securities.....	5,178,829	5,042,999	6.0 - 9.0%	15 years - 30 years
Securities purchased with cash collateral under securities lending program:				
Asset backed securities.....	10,314,880	Not applicable	1.88 - 7.15%	15 days - 3 years
Corporate bonds and notes.....	1,234,909	Not applicable	1.86 - 2.0%	46 days - 1 year
U.S. government and agency securities.....	746,727	Not applicable	1.77 - 2.08%	122 days - 241 days
Equity-based trust.....	27,032,435	Not applicable	Not applicable	Not applicable

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The equity-based trust is an investment in a trust fund managed by third party money managers. The trust fund invests in common stocks and other equity-type securities. For this investment, the State Treasurer does not own individual securities but rather has ownership in the trust.

Included in the "asset backed securities" investment category are mortgage-backed securities issued by an agency of the United States government, the Government National Mortgage Association (GNMA). The State Treasurer invests in these securities to maximize yield while maintaining a high degree of safety. The securities are based on cash flows from payments on underlying mortgages. Although these investments are not derivatives, the investment values are sensitive to mortgage prepayments that tend to occur during periods of declining interest rates.

Included in the equity-based trust are stock futures and foreign exchange forward contracts. The trust has entered into these and similar contracts to deliver returns similar to the appropriate industry benchmarks. Derivative positions are accounted for both by the custodian and the investment manager on separate accounting platforms. Both total exposure and realized and unrealized gains and losses are calculated on a daily basis. The positions are reconciled daily with the clearing brokers. The trust enters into these transactions with industry standard brokerage account forms that are binding by all affected parties. The futures exchanges mediate counterparty credit risk with daily mark-to-market valuations of all futures positions. The money movements are handled by a clearing corporation affiliated with each exchange. Market risks associated with these transactions are the same as the underlying securities.

At year end, the balances of the bond proceeds investments were as follows (dollars in thousands):

Bond Proceeds	Category	Carrying
Investments Categorized:	1	Amount
Repurchase agreements...	\$ 663,282	\$ 663,282
Total Investments.....	<u>\$ 663,282</u>	<u>\$ 663,282</u>

The Bond Proceeds Investment Accounts also invested in U.S. government and agency securities and commercial paper during the year, but such assets were not owned at year-end.

Securities Lending

Based on the authority provided in G.S. 147-69.3(e), the State Treasurer lends securities from its Investment Pool to broker-dealers and other entities (borrowers) for collateral that will be returned for the same securities in the future. The Treasurer's securities custodian manages the securities lending program. During the year the custodian lent U.S. government securities, corporate bonds and notes for collateral. The custodian is permitted to receive cash, U.S. government securities, or irrevocable letters of credit as collateral for the securities lent. The collateral is initially pledged at 102 percent of the market value of the securities lent, and additional collateral is required if its value falls to less than 100 percent of

the market value of the securities lent. There are no restrictions on the amount of loans that can be made. Substantially all security loans can be terminated on demand by either the State Treasurer or the borrower. Securities lent at year-end for cash collateral are presented as unclassified in the preceding schedule of custodial credit risk; securities lent for securities collateral are classified according to the category for the collateral. The State Treasurer cannot pledge or sell the collateral securities received unless the borrower defaults.

The cash collateral received is invested by the custodian agent and held in a separate account in the name of the State Treasurer. The average maturities of the cash collateral investments are less than the average maturities of the securities lent. While cash can be invested in securities ranging from overnight to two years, the custodian agent is not permitted to make investments where the weighted average maturity of all investments exceeds 90 days. At June 30, 2002, the weighted average maturity of unmatched investments was approximately 22 days.

At year-end, the State Treasurer had no credit risk exposure to borrowers because the amounts the Treasurer owed the borrowers exceeded the amounts the borrowers owed the State. The securities custodian is contractually obligated to indemnify the Treasurer for certain conditions, the two most important are default on the part of the borrowers and failure to maintain the daily mark-to-market on the loans.

B. Deposits Outside the State Treasurer

In addition to the pooled deposits maintained by the State Treasurer, other deposits are maintained outside the State Treasurer by the primary government and by certain component units. As a general rule, these deposits are not covered by the rules in Chapter 20 NCAC 7 requiring collateralization of uninsured deposits.

Primary Government

At June 30, 2002, the deposits maintained outside the State Treasurer by the primary government consisted of (dollars in thousands):

	Carrying Value	Bank Balance
Demand.....	\$ 20,098	\$ 22,040
Time.....	1,350,343	1,363,335
Total Deposits.....	<u>\$ 1,370,441</u>	<u>\$ 1,385,375</u>

Of these bank balances, \$433.290 million was covered by federal depository insurance, \$449.675 million by collateral held by the escrow agent in the depositor's name, and \$502.410 million was uninsured and uncollateralized.

NOTES TO THE FINANCIAL STATEMENTS**Component Units****(University of North Carolina System, Golden LEAF, State Education Assistance Authority, North Carolina Housing Finance Agency, and Community Colleges)**

At June 30, 2002, the deposits maintained by the University of North Carolina System consisted of (dollars in thousands):

	<i>Carrying Value</i>	<i>Bank Balance</i>
Demand.....	\$ 36,886	\$ 14,812
Time.....	12,091	16,910
Total Deposits.....	<u>\$ 48,977</u>	<u>\$ 31,722</u>

Of these bank balances, \$4.381 million was covered by federal depository insurance, \$0.965 million by collateral held by the escrow agent in the depositor's name, \$2.751 million was covered by collateral held in the pledging bank's trust department in the depositor's name and \$23.625 million was uninsured and uncollateralized.

At June 30, 2002, the deposits maintained by the Golden LEAF consisted of (dollars in thousands):

	<i>Carrying Value</i>	<i>Bank Balance</i>
Demand.....	\$ 489	\$ 1,157
Time.....	308	308
Total Deposits.....	<u>\$ 797</u>	<u>\$ 1,465</u>

Of these bank balances, \$0.500 million was covered by federal depository insurance and \$0.965 million was uninsured and uncollateralized.

At June 30, 2002, the deposits maintained by other major component units consisted of (dollars in thousands):

	<i>Carrying Value</i>	<i>Bank Balance</i>
Demand.....	\$ 3,585	\$ 6,678
Time.....	55,379	65,510
Total Deposits.....	<u>\$ 58,964</u>	<u>\$ 72,188</u>

Of these bank balances, \$9.406 million was covered by federal depository insurance, \$13.920 million by collateral held by the escrow agent in the depositor's name, \$41.009 million was covered under the State Treasurer's collateral pool and \$7.853 million was uninsured and uncollateralized.

C. Investments Outside the State Treasurer

Investments in participating investment contracts, external investment pools, open-end mutual funds, debt securities, equity securities, and all investments of the Deferred Compensation Plan are reported at fair value. Investments in certificates of deposit, investment agreements, bank investment contracts, real estate, real estate investment trusts, and limited partnerships are reported at cost. Detailed disclosures about investments held outside the State Treasurer are presented below.

Primary Government

All organizations within the primary government are required to follow certain investment guidelines as outlined by the General Statutes. Of these organizations, the various clerks of superior court, the N.C. Deferred Compensation Plan (457), and the 401(k) Supplemental Retirement Income Plan comprise 99% of the total investments maintained by the primary government at June 30, 2002. The investments by these funds adhere to the following General Statutes guidelines.

General Statute 7A-112(a) authorizes the Clerk of the Superior Court to invest in obligations of or fully guaranteed by the United States; obligations of the State of North Carolina; general obligations of North Carolina local governments; and shares, deposits, savings certificates, and certificates of deposits of specified institutions.

General Statute 143B-426.25(j) allows the Deferred Compensation Plan Board to acquire investment vehicles from any company authorized to conduct such business in this State or may establish, alter, amend and modify, to the extent it deems necessary or desirable, a trust for the purpose of facilitating the administration, investment and maintenance of assets acquired by the investment of deferred funds. Any assets of such investment vehicles or trusts shall remain solely the property and rights of the State subject only to the claims of the State's general creditors.

General Statute 135-90 places no specific investment restrictions on the 401(k) Supplemental Retirement Income Plan. However, in the absence of specific legislation, the form of governance over the investments would be the prudent-person or prudent-expert rule. These rules are broad statements of intent, generally requiring investment selection and management to be made with prudent, discreet, and intelligent judgment and care.

NOTES TO THE FINANCIAL STATEMENTS

At year end the investment balances maintained outside the State Treasurer for the primary government were as follows (dollars in thousands):

	Category			Carrying
	1	2	3	Amount
Investments Categorized:				
U.S. Government securities.....	\$ 1,520	\$ 562	\$ 213	\$ 2,295
State and municipal securities.....	2,300	—	—	2,300
Corporate bonds.....	—	—	694	694
Corporate common stock.....	22,183	—	1,162	23,345
<i>Total Investments Categorized.....</i>	<u>\$ 26,003</u>	<u>\$ 562</u>	<u>\$ 2,069</u>	<u>28,634</u>
Investments Not Categorized:				
				5,861
				1,921,393
				252,831
Total Investments.....				<u>\$ 2,208,719</u>

Component Units

(University of North Carolina System, Golden LEAF, State Education Assistance Authority, North Carolina Housing Finance Agency, and Community Colleges)

The component units of the State are required to follow certain investment guidelines as outlined by the General Statutes.

General Statute 115D-58.6 authorizes the community colleges to invest in obligations of or fully guaranteed by the United States; obligations of the State of North Carolina; bonds and notes of any North Carolina local government or public authority; obligations of certain non-guaranteed federal agencies; prime quality commercial paper; the North Carolina Capital Management Trust, an SEC registered mutual fund; commingled investment pool established and administered by the State Treasurer; repurchase agreements; and evidences of ownership of, or fractional undivided interests in, future interest and principal payments on direct obligations of or fully guaranteed by the United States government, which are held by a specified bank or trust company or any state in the capacity of custodian.

General Statute 122A-11 authorizes the North Carolina Housing Finance Agency to invest in shares of or deposits in banks or trust companies outside as well as in this State, provided any such moneys on deposit outside this State are collateralized to the same extent and manner as if deposited in this State; evidences of ownership of, or fractional undivided interests in, future interest and principal payments on direct obligations of or fully guaranteed by the United States government, which are held by a specified bank or trust company or any state in the capacity of custodian; obligations which are collateralized by mortgage pass-through securities guaranteed by the Government National Mortgage Association, the Federal Home Loan Mortgage Corporation, or the Federal National Mortgage Association; trust certificate or similar instrument evidencing an equity investment in a trust or similar arrangement, which is formed for the purpose of issuing obligations which are collateralized by mortgage pass-through or participation certificates guaranteed by the Government

National Mortgage Association, the Federal Home Loan Mortgage Corporation, or the Federal National Mortgage Association; and repurchase agreements.

The State Education Assistance Authority is authorized by the University of North Carolina Board of Governors pursuant to General Statute 116-36.2 to invest its special funds in the same manner as the State Treasurer is required to invest, as discussed in Section A of this note.

The General Statutes place no specific investment restrictions on the University of North Carolina System or the Golden LEAF. However, in the absence of specific legislation, the form of governance over these investments would be the prudent-person or prudent-expert rule. These rules are broad statements of intent, generally requiring investment selection and management to be made with prudent, discreet, and intelligent judgment and care. The University of North Carolina at Chapel Hill operates an Investment Fund, which is a governmental external investment pool. The University operates the Investment Fund for charitable, nonprofit foundations, associations, trusts, endowments and funds that are organized and operated primarily to support the University. Separate financial statements for the Investment Fund may be obtained from the University.

NOTES TO THE FINANCIAL STATEMENTS

At year end, investment balances maintained outside the State Treasurer for the University of North Carolina System were as follows (dollars in thousands):

	Category			Carrying Amount
	1	2	3	
Investments Categorized:				
U.S. Government securities.....	\$ 112,381	\$ 25,310	\$ 4,035	\$ 141,726
Collateralized mortgage obligations.....	69,191	11,745	—	80,936
State and municipal securities.....	5,313	60	—	5,373
Corporate bonds.....	76,382	15,744	31	92,157
Corporate common stock.....	171,488	70,758	698	242,944
Repurchase agreements.....	—	—	1,602	1,602
Commercial paper.....	6,587	—	—	6,587
International corporate bonds.....	1,231	—	—	1,231
International government bonds.....	801	—	—	801
International equity securities.....	1,733	1,104	—	2,837
Total Investments Categorized.....	\$ 445,107	\$ 124,721	\$ 6,366	576,194
Investments Not Categorized:				
Money market funds.....				141,848
Mutual funds.....				681,209
Annuity contracts.....				143
Real estate.....				34,741
Real estate investment trust.....				18,474
Limited partnerships.....				421,551
Investments held by broker-dealers under reverse repurchase agreements:				
U.S. Government securities.....				34,486
Pooled investments.....				219
Other investments.....				33,048
Total Investments.....				\$ 1,941,913

At year end, investment balances maintained outside the State Treasurer for the Golden LEAF were as follows (dollars in thousands):

	Category	Carrying Amount
	3	
Investments Categorized:		
U.S. Government securities.....	\$ 25,973	\$ 25,973
Corporate bonds.....	31,146	31,146
Corporate common stock.....	97,646	97,646
Total Investments Categorized.....	\$ 154,765	154,765
Investments Not Categorized:		
Money market funds.....		9,912
Real estate.....		19,049
Limited partnerships.....		20,282
Other investments.....		31,942
Total Investments.....		\$ 235,950

At year end, investment balances maintained outside the State Treasurer for other major component units were as follows (dollars in thousands):

	Category			Carrying Amount
	1	2	3	
Investments Categorized:				
U.S. Government securities.....	\$ 93,944	\$ —	\$ 45	\$ 93,989
Corporate bonds.....	210	1,466	5	1,681
Corporate common stock.....	1,698	3,215	5,569	10,482
Repurchase agreements.....	229,134	—	—	229,134
Total Investments Categorized.....	\$ 324,986	\$ 4,681	\$ 5,619	335,286
Investments Not Categorized:				
Money market funds.....				1,130
Mutual funds.....				33,517
Real estate.....				905
N.C. Capital Management Trust.....				790
Other investments.....				27
Total Investments.....				\$ 371,655

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Included in the “U.S. government securities” investment category are mortgage-backed securities issued by agencies of the United States government, the Government National Mortgage Association (GNMA) and the Federal National Mortgage Association (FNMA). The University of North Carolina at Chapel Hill and the North Carolina Housing Finance Agency invest in these securities to maximize yield while maintaining a high degree of safety. The securities are based on cash flows from payments on underlying mortgages. Although these investments are not derivatives, the investment values are sensitive to mortgage prepayments that tend to occur during periods of declining interest rates.

Derivatives are not widely used by the various component units investing outside the State Treasurer. Of the above balances, only the Collateralized Mortgage Obligations (CMOs) and certain investments held by limited partnerships were considered material derivative positions during the year.

Collateralized Mortgage Obligations - The University of North Carolina at Chapel Hill, North Carolina State University, and UNC Hospitals invest in collateralized mortgage obligations (CMOs) issued by FNMA, FHLMC and by certain trusts and private corporations. In a CMO, cash flows from principal and interest payments from one or more mortgage pass-through securities or a pool of mortgages may be reallocated to multiple classes with different priority claims and payment streams (commonly referred to as tranches.) A holder of the security thus chooses the class of security that best meets risk and return objectives. CMOs are subject to significant market risk due to fluctuations in interest rates, prepayment rates, and various liquidity factors related to their specific markets. The universities and UNC Hospitals invest in these securities to increase the yield and return on their investment portfolios given the available alternative investment opportunities.

Limited Partnerships – The limited partnership positions are primarily held by the University of North Carolina at Chapel Hill. The University uses various external money managers to identify specific investment funds and limited partnerships that meet asset allocation and investment management objectives. The University invests in these funds and partnerships to increase the yield and return on its investment portfolio given the available alternative investment opportunities and to diversify its asset holdings. These investments generally include equity and bond funds. Certain investment funds expose the University to significant amounts of market risk by trading or holding derivative securities and by leveraging the securities in the fund. The University limits the amount of funds managed by any single asset manager and also limits the amount of funds to be invested in particular security classes.

Reverse Repurchase Agreements - The University of North Carolina at Chapel Hill enters into fixed coupon reverse repurchase agreements, that is, the sale of securities with a simultaneous agreement to repurchase them in the future at the same price plus a contract rate of interest. The fair value of the

securities underlying reverse repurchase agreements normally exceeds the cash received, providing dealers a margin against a decline in fair value of the securities. If the dealers default on their obligations to resell these securities to the University or provide securities or cash of equal value, the University would suffer an economic loss equal to the difference between the fair value plus accrued interest of the underlying securities and the agreement obligation, including accrued interest. The credit exposure at year-end was \$324,396. All sales under reverse repurchase agreements are for fixed terms. The University’s practice for investing the proceeds of reverse repurchase agreements is for the term to maturity of the investment to be the same as the term of the reverse repurchase agreement.